9 March 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

AASB comments on IASB Exposure Draft ED/2010/13 *Hedge Accounting*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft ED/2010/13 *Hedge Accounting*. In formulating its views, the AASB sought the views of Australian constituents.

The AASB is supportive of the objective of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* in order to improve and simplify the accounting requirements for financial instruments. In particular, the AASB supports the IASB's decision to undertake a comprehensive review of the hedge accounting requirements to develop a more principles-based approach that has the potential to provide more meaningful information.

The AASB acknowledges that the global financial crisis highlighted that users of general purpose financial statements require better information to understand an entity's hedge accounting activities, how they reflect an entity's risk management activities and the extent to which those activities are successful in meeting an entity's risk management objective. The AASB notes that the proposals in this ED respond to many of the concerns regarding the lack of transparency in the accounting for an entity's hedging activities.

Whilst the AASB supports the overall thrust of the ED, we do believe that a number of areas warrant further consideration. These include:

(a) linking the hedge accounting objective to an 'entity's risk management strategy' – there are concerns that the meaning of an 'entity's risk management strategy' is unclear and too broad, which could result in an increased use of hedge accounting and potentially result in inappropriate uses of hedge accounting. In addition, the AASB is also concerned that there are a number of deviations from the principle that have not been properly justified – see responses to Questions 1, 2, 8, 11, 15 and 16;

(b) the focus of the objective on managing exposures that impact profit or loss – the AASB is concerned that the objective has impacted other requirements proposed in the ED (for example, the proposal to prohibit instruments measured at fair value through other comprehensive income (OCI) from being designated as hedged items) and that the IASB has not provided sufficient justification for its decisions. This is especially of concern if an entity would normally form a hedging relationship consistent with its risk management strategy, but the requirements do not permit its designation;

(c) the hedge effectiveness requirements – whilst the AASB is supportive of the removal of the bright line rules in IAS 39 around hedge effectiveness testing, the proposals introduce a number of new terms that are not defined, and this is likely to result in diversity in practice;

(d) the rebalancing requirements – the AASB believes more guidance is required around the proposals;

(e) the removal of the election to voluntarily discontinue hedge accounting – the proposal seems to be an unnecessary bright line rule to mitigate the concerns raised in the Alternative View about entities moving more freely into and out of hedge accounting. The AASB believes if the entity's risk management strategy is to enter and exit hedging relationships to mitigate risk exposures, then not allowing entities to voluntarily discontinue hedge accounting is inconsistent with the IASB's stated objective of hedge accounting;

(f) the proposed treatment of the fair value of the time value of an option is not sufficiently justified – whilst there may be some merit in the treatment of the time value of options proposed by the IASB, the AASB does not believe that it is consistent with the treatment of acquisition costs in other IFRSs;

(g) the decision regarding the treatment of the time value associated with zero cost collars – the IASB's decision to not treat the time value in zero cost collars in the same way as options seems arbitrary and will likely give rise to structuring opportunities;

(h) the requirement for a net position to be designated as a hedged item only if the offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period – this will have a significant impact on entities that report on a quarterly or half-yearly basis. The inability to achieve hedge accounting in this instance will conflict with an entity's risk management strategy and therefore, the IASB should justify its decision;

(i) the interaction between the disclosure requirements in AASB 7 *Financial Instruments: Disclosures* and the proposed disclosures – the AASB is concerned that the disclosure requirements may be onerous and that there may be repetition in the requirements for identifying an entity's risk exposures and the entity's risk management policies;

(j) the discussion around the hedging of credit risk is inconsistent with the IASB's previous decision to require the measurement and separate presentation of fair value changes due to changes in an entity's credit risk for financial liabilities designated at fair value through profit or loss in OCI – the AASB believes that the IASB needs to justify its decision;

(k) prospective application – it is not clear what the IASB's means by 'prospective' in the proposals. In addition, the AASB believes that providing a once-off retrospective adjustment on transition to the new requirements may be warranted, especially in instances where there are long-dated existing hedging relationships and applying the requirements prospectively would require the entity to keep two sets of hedging books and report different results for the same type of hedging relationship; and

(l) consideration of hedge transactions that an entity may undertake for risk management purposes that will not achieve hedge accounting under the proposals. If these types of transactions will not achieve hedge accounting, then the IASB needs to explain why and clarify the meaning of the phrase 'manage its exposures' in the objective.

An additional overriding concern is the IASB's increasing use of OCI, despite the fact that the IASB is yet to establish a generally accepted principle for determining which items should be presented in OCI. The AASB strongly urges the IASB to finish its project on financial statement presentation to determine a basis for presenting items in OCI.

It seems to the AASB that the IASB intends to press ahead with its hedging proposals, even if the FASB is not in agreement. The AASB remains concerned about the relative lack of success so far in having the two Boards come to the same conclusion on financial instruments topics. However, if forced to choose between the two Board's proposals for hedging, we would support the approach of the IASB.

The AASB has provided input into the response prepared by the Asian-Oceanian Standards Setters Group (AOSSG). Accordingly, there may be issues raised in both the AASB and AOSSG submissions.

If you have any queries regarding any matters in this submission, please contact me or Natalie Batsakis (nbatsakis@aasb.gov.au).

Yours sincerely

Kevin Stevenson
Chairman and CEO

IASB Exposure Draft ED/2010/13 *Hedge Accounting*

AASB specific comments

The AASB provides the following responses to the IASB's Exposure Draft ED/2010/13 *Hedge Accounting.*

Objective of hedge accounting (paragraphs 1 and BC11-BC16)

> **Question 1**
>
> Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

The AASB acknowledges the view that linking hedge accounting to an entity's risk management activities can provide greater transparency. More of the 'economic hedges' that previously did not qualify for hedge accounting will be disclosed in the financial statements in a way that is expected to better reflect the underlying substance of the transaction – in effect, better reflecting the reason for, and the way in which, the transaction was undertaken, to provide users with an improved understanding of the activities of the entity in the financial statements. However, the AASB has a number of concerns with the proposed objective.

(i) *Linking the objective to an entity's risk management strategy*

The AASB shares some of the concerns of John T Smith (as expressed in the Alternative View) that linking hedge accounting to an entity's risk management strategy will result in hedge accounting being more widely used, rather than an exception to 'normal' recognition and measurement requirements. The potential for an entity to override the fair value option (which is an irrevocable election at initial recognition) by electing to hedge account has already been identified in the Alternative View in ED/2010/13. The AASB believes that the boundaries of the term 'risk management' should be explored further such that entities cannot move freely in and out of hedge accounting to manage earnings.

In addition, the AASB believes that there are inconsistencies within the ED which proposes that an entity's hedge accounting should reflect its risk management strategy, while there are still a number of hedging transactions that take place in practice and pose real commercial risks to an entity, that cannot achieve hedge accounting – see (iii) below.

(ii) *Focussing on the impact to profit or loss*

The proposed objective is focussed on managing exposures that could affect only profit or loss and it is clear that this decision has impacted other requirements proposed in the ED, such as:

(1) the proposal to prohibit instruments measured at fair value through other comprehensive income (OCI) from being designated as hedged items. This appears consistent with the hedging objective of managing exposures that could affect profit or loss. However, there is nothing in IAS 39 that currently prevents entities from hedging investments in equity instruments that are not held for trading (previously classified as available-for-sale assets) whose movements in fair value are recognised in OCI, and there are entities that hedge those types of investments in accordance with their risk management strategy and would wish to apply hedge accounting;

(2) the proposal to prohibit non-derivative financial instruments that are not measured at fair value through profit or loss from being designated as hedging instruments. The AASB does not believe the IASB has provided sufficient justification for excluding this type of instrument; and

(3) the proposal that the accounting for fair value hedges would require gains or losses from the hedged item and hedging instrument to be recorded in OCI and any ineffectiveness to be transferred to profit or loss. In previous submissions, the AASB raised the concern that recycling from OCI to profit or loss undermines the notion that items of revenue are 'income' and items of expense are 'expenses', regardless of where they are presented in the statement of comprehensive income. Therefore, the AASB believes the IASB should clearly articulate and justify its focus on risks that affect profit or loss rather than comprehensive income, to ensure there is a conceptual basis for determining the types of assets that can be designated as hedged items.

The AASB is concerned the IASB is taking a view on the nature of items that are presented in profit and loss, as opposed to in OCI, in a number of projects without identifying an underlying principle, and the hedging proposals compound this concern. The AASB urges the IASB to finish its financial statement presentation project and identify the basis for presenting items in equity versus OCI versus profit or loss, so that it is understood, at a conceptual level, what it means to present items in the different areas of the financial statements.

If the IASB would treat with adequate status and clear rationales both profit and loss and OCI, fair value hedging could be markedly simplified. Ineffectiveness could be measured in OCI and would not need to be recycled.

(iii) *Defining what is meant by "...manage exposures arising from particular risks..."*

The AASB believes that the IASB should clarify what it means by 'manage exposures', because as discussed in (i) above, there are still a number of hedge transactions that take place but for which hedge accounting cannot be achieved. Therefore, the proposals for hedge accounting will not fully capture an entity's risk management activities. Some examples are provided in Appendix B to this submission.

If the IASB intends that the examples provided should not be eligible for hedge accounting, then it should clarify the meaning of 'manage exposures'. The AASB considers that managing exposures should mean mitigating risk and does not include the conversion or swapping from one type of risk exposure to another.

(iv) *Hedge accounting as an option*

Given the AASB's preference for all financial instruments to be measured at fair value through profit or loss, the AASB is not opposed to retaining hedge accounting as an option. In addition, requiring mandatory application of hedge accounting could be too costly for some entities. However, the AASB notes that linking the objective of hedge accounting with an entity's risk management strategy could be inferred to mean that an entity that undertakes hedging transactions but chooses not to apply hedge accounting, would not need to reflect its risk management strategy in its financial statements.

The AASB considers this would be unfortunate because risk management could also be reflected in disclosures and suggests that the IASB identify this in finalising its hedge accounting amendments.

Instruments that qualify for designation as hedging instruments (paragraphs 5-7 and BC28-BC47)

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

The AASB agrees that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments. However, as discussed in the response to Question 1 above, the AASB does not believe there is sufficient justification for only allowing non-derivative financial instruments measured at fair value through profit or loss to be designated as eligible hedging instruments. If the entity's risk management strategy is to use assets and liabilities measured at fair value through OCI to hedge a risk exposure, then disallowing it will result in inconsistency between the objective of hedge accounting and the entity's risk management strategy.

Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48-BC51)

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

Yes. The AASB supports the proposal to expand the exposures eligible for designation as a hedged item. Synthetic exposures are commonly created due to the way in which loans are originally hedged (as discussed in the example in paragraph BC50 of the Basis for Conclusions in ED/2010/13). Therefore, the AASB believes that any remaining variability in cash flows or fair value should be able to be accounted for consistent with an entity's risk management activities.

However, the AASB believes guidance is needed in this area. The proposals have raised a number of concerns. For example:

(a) is it necessary for the first hedge to meet the hedge accounting criteria, or only the combined hedge?

(b) not all these types of hedges will be transacted at inception – therefore, if the first hedge is transacted and subsequently the entity decides to enter the second hedge, would this be a change in risk management strategy such that the first hedge should be discontinued?

Designation of risk components as hedged items (paragraphs 18, B13-B18 and BC52-BC60)

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

The AASB agrees with the proposal to expand on the requirements in IAS 39 to allow an entity to designate changes in the cash flows or fair value of either a financial or non-financial item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable.

The AASB believes the wording in paragraph 18 should be expanded to include the guidance in paragraph B13 to more clearly articulate the principle that, if an entity cannot determine the impact of the risk component on the hedged item then it is not considered to be reliably measurable. Therefore, paragraph 18 could be amended to read as follows:

(a) "only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided the risk component is separately identifiable and the changes in the cash flows or fair value of the item attributable to changes in that risk component are reliably measurable."

Additionally, the example within the discussion in paragraph B18 regarding the treatment of inflation as a risk component of a financial instrument could potentially be viewed as a rule that overrides the principle that a risk component must be separately identifiable and reliably measurable. If the guidance is a legacy paragraph from IAS 39 from a previous interpretation, and the IASB does not wish to re-address the issue, it should be more specific with the example. This would involve providing an explanation regarding the example such as, the interest and inflation components are inextricably linked and cannot be separated, therefore resulting in the inflation component not being separately identifiable and reliably measurable.

Designation of a layer component of the nominal amount (paragraphs 18, B19-B23 and BC65-BC69)

Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

Yes. The AASB agrees with the proposals outlined in questions 5(a) and 5(b) above in respect of the designation of a layer component of the nominal amount for the reasons outlined in paragraphs BC65-BC69 of the Basis for Conclusions.

Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27-B39 and BC75-BC90)

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

The AASB believes that there should be hedge effectiveness requirements as part of the qualifying criteria for hedge accounting. Additionally, the AASB welcomes the removal of the 'bright-line' effectiveness testing rules under IAS 39. However, the AASB is concerned that the requirements have been drafted in an overly complex manner and there would be confusion around the meaning of various terms being used (including 'unbiased' and 'accidental offset') and how the requirement for an entity to minimise expected hedge ineffectiveness will be applied in practice. Requiring hedging relationships to give unbiased results and minimise expected ineffectiveness may be seen as an onerous and overly complicated task in practice, while providing limited benefit to users.

If the IASB intends to retain these requirements, the AASB believes that the proposed wording could be simplified.

Paragraph 19(c) notes that, in order for a hedging relationship to qualify for hedge accounting, the hedging relationship must "...meet the hedge effectiveness requirements (see paragraphs B27-B39)...", which are that the hedging relationship:

(i) meets the objective of the hedge effectiveness assessment; and

(ii) is expected to achieve other than accidental offsetting.

Three new phrases are introduced in the above paragraph – (1) 'hedge effectiveness requirements', (2) 'hedge effectiveness assessment' and (3) 'accidental offsetting'. In respect of (1), the hedge effectiveness requirements are clearly explained in sub-paragraphs 19(c)(i) and (ii).

However, phrases (2) and (3), are not discussed further in the proposed amendments to the body of IFRS 9. The only indication of where to find an explanation of what is meant by 'hedge effectiveness assessment' and 'accidental offsetting' is the reference to paragraphs B27-B39 in the Application Guidance (Appendix B).

The first mention of 'hedge effectiveness assessment' is not until paragraph B29, stating that its objective "...is to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Therefore, a hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create ineffectiveness."

The discussion on 'accidental offsetting' is located in paragraph B31, which notes that, when a relationship between the changes in the value of the hedged item and the hedging instrument breaks down (i.e. due to a deterioration in the credit standing of the issuer of the derivative), it would not be expected that the hedging relationship could achieve other than accidental offsetting – and as such, would fail to meet the hedge effectiveness requirements.

When considering the objective of the 'hedge effectiveness assessment', and the discussion on 'accidental offsetting', it seems that sub-paragraph (ii) repeats the intention of sub-paragraph (i) – if a hedging relationship is expected to 'achieve other than accidental offsetting' then one would expect that the hedging relationship is one which will produce an 'unbiased result and minimise expected hedge ineffectiveness'.

The AASB believes that the requirements could be made clearer if the objective of the hedge effectiveness assessment were included as part of the qualifying criteria in paragraph 19(c). The paragraph could be amended to simply say:

> "A hedging relationship must be expected to produce an unbiased result and minimise expected hedge ineffectiveness."

Although this would eliminate the 3 phrases which are undefined, the AASB believes that the Application Guidance should articulate the intended meaning of 'an unbiased result' and expand on the discussion regarding how an entity minimises hedge ineffectiveness and obtains other than accidental offsetting.

Rebalancing of a hedging relationship (paragraphs 23, B46-B60 and BC106-BC111)

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

Despite concerns that the requirement could be onerous to implement, the AASB agrees with the proposal to require an entity to rebalance the hedging relationship if the hedging relationship fails to meet the objective of the hedge effectiveness assessment or if it is not expected to do so, because this means entities can continue hedge accounting and will not be forced to de-designate the hedge relationship where it still meets the entity's risk management strategy.

It is our understanding that in both instances, rebalancing will take place after hedge effectiveness is assessed and hedge effectiveness for the following period would be based on the rebalanced hedge relationship. The AASB believes the IASB's intention should be made clear.

In addition, there are other issues the AASB believes require clarification:

(a) *Replacement of old terminology* – it is not clear if the IASB is totally replacing its old terminology (de-designation and re-designation) with new terms (rebalancing, continuation and discontinuation), because there are a number of instances when the term de-designation is used in the Application Guidance. The IASB should ensure that the terms are used in a consistent manner so as to avoid confusion – for example what is the difference between 'de-designation' and 'discontinuation'?;

(b) *What constitutes a rebalancing event?* – whether a delay in the timing of the hedged item would be a rebalancing event (for example, if the entity is hedging sales of its inventory for a particular date, but its manufacturing process breaks down, resulting in delays on production and ultimately delaying the sales date);

(c) *Rebalancing vs. overhaul event* – paragraph BC110 of the Basis for Conclusions introduces the term 'overhaul'. This concept is not discussed elsewhere in the proposals and the AASB believes it is inappropriate to introduce a new notion in the Basis for Conclusions. In order to avoid interpretative issues, the AASB believes that this notion should be defined/articulated in the Application Guidance, along with detailed discussion of what would constitute an overhaul event versus a rebalancing event. Additionally, the IASB should clarify why the example of a severe deterioration in the credit risk of a hedging instrument is an overhaul and not a rebalancing event.

The AASB strongly encourages the IASB to clarify these issues around the newly introduced idea of rebalancing and ensure that the terms are appropriately defined/explained in the final standard.

Discontinuing hedge accounting (paragraphs 24, B61-B66 and BC112-BC118)

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

The AASB agrees that an entity should discontinue hedge accounting prospectively when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria. However, the AASB is concerned with the proposal in the ED that prevents an entity from voluntarily discontinuing hedge accounting. The proposal appears to be an unnecessary 'bright-line' rule to mitigate the concerns raised in the Alternative View that linking hedge accounting to risk management activities would "...inappropriately expand the use of hedge accounting...", thereby making hedge accounting "...the norm and not the exception..." to recognition and measurement principles. If the concern of the IASB is to prevent entities from discontinuing hedge accounting for no reason, then this should be clarified and clearly expressed in the final standard.

Paragraph 91(c) of IAS 39 currently allows an entity to revoke its designation of the hedge accounting relationship and prospectively discontinue hedge accounting. Whilst it is expected that the majority of circumstances when revocation may have been used will be replaced with rebalancing, the AASB considers that revocation should remain available because entities often dismantle hedging positions for valid business reasons not associated with a change in risk management strategy.

If the entity's risk management strategy is to enter and exit hedging relationships to mitigate risk exposures, then not allowing entities to voluntarily discontinue hedge accounting is inconsistent with the IASB's stated objective of hedge accounting. Therefore, there should not be a difference in accounting if an entity terminates and pays out the hedging instrument or takes out a new instrument to offset the gains/losses on the designated hedging instrument – the accounting should reflect this regardless of whether the entity's overall risk management strategy remains unchanged.

Accounting for fair value hedges (paragraphs 26-28 and BC119-BC129)

Question 9

(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

As discussed in the response to Question 1, the AASB has an overriding concern with the number of items being recognised in OCI prior to the completion of the IASB's presentation project. The AASB strongly encourages the IASB to finish its project on financial statement presentation to help ensure consistency in the items presented in OCI.

Additionally, the AASB acknowledges the feedback from user groups that separately presenting the gain or loss on the hedged item would provide useful information, because under the existing IAS 39 requirements it can be difficult to decipher the carrying amount of an asset (its amortised cost) and the portion that reflects adjustments made for hedging purposes. However, the AASB is concerned that the presentation in the balance sheet is not appropriate as the adjustment for the fair value gain or loss on the hedged item would not be an element – that is, it would not meet the definition of an asset or a liability.

Therefore, the AASB believes the IASB should reconsider its proposals on the appropriateness of the mechanics proposed for accounting for fair value hedges.

Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67-B69 andBC143-BC155)

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Treatment of the time value of options

The AASB acknowledges the pressure on the IASB to address the volatility recognised in profit or loss caused by the existing requirement in IAS 39 to treat the time value of options as held for trading, resulting in its measurement at fair value through profit or loss. Additionally, the AASB does not believe that accounting requirements should drive an entity's decision regarding its risk management strategy. However, the AASB does not believe the IASB has identified an appropriate solution.

The AASB believes all hedging instruments can be viewed as providing 'insurance' to the entity. Therefore, the AASB does not consider it appropriate to treat the time value of an option as a cost of hedging in isolation of other instruments because:

(a) there are other types of instruments that have a time value component – for example, forward foreign exchange contracts. The recognition and measurement requirements for a time value component should be applied consistently across all types of instruments;

(b) costs are associated with a number of off-market derivatives and there are implied costs in other instruments. Again, the associated 'costs' of hedging instruments should be treated in the same manner. In addition, the AASB does not believe the measurement of a derivative should exacerbate the accounting for transaction costs; and

(c) IFRSs do not always capitalise costs associated with acquiring assets; for example:

   (i) IFRS 3 *Business Combinations* – transaction costs incurred in a business combination are expensed in profit or loss at the date of acquisition; and

   (ii) IAS 23 *Borrowing Costs* – borrowing costs are not capitalised to form part of the cost of an asset unless they are directly attributable to the acquisition, construction or production of a qualifying asset.

Zero cost collars

The AASB believes the current proposals in respect of the treatment of the time value associated with zero cost collars are not appropriate and may encourage entities to undertake particular types of transactions – zero cost collars would be replaced by collars with a nominal cost so that the proposed accounting treatment for options can be applied (for example – $10 collars would become a feature in the market).

Conceptually, the AASB remains very concerned that the IASB seems willing to separate the components of fair value in a way that leaves the element in profit or loss meaningless. It seems, when one steps back from the mechanics of the treatment of the time value of an option, as if the objective is to account for the historical cost of an explicit option premium by basis adjusting underlying transactions or balances. This seems at odds with the notion that the only relevant measurement attribute of a derivative is its fair value. The movement in any element of fair value should not be viewed as "noise", but rather as part of the opportunity gain or loss of holding the derivative. It is irrelevant that the entity intends to hold the derivative and that time value will reverse. Further, the use of a location other than profit or loss for other value changes, combined with the Board not seemingly want to accord OCI appropriate status, makes the accounting for options seem opportunistic. We wonder also how it will bias practice.

<u>Hedges of a group of items (paragraphs 34-39, B70-B82 and BC156-BC182)</u>

Eligibility of a group of items as the hedged item (paragraphs 34, B70-B76, BC163, BC164 and BC168-BC173)

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

Whilst the AASB supports the criteria for the eligibility of groups of items as a hedged item, there are concerns regarding the requirement for a net position to be designated as a hedged item only if the offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period. An entity's risk management strategy may be to hedge on a net basis, even though not all hedged items will affect profit or loss in the same reporting period, and the effect of this restriction would be even more significant for entities that report on a quarterly or half-yearly basis.

Therefore, the restriction on hedges of net positions in cash flow hedges may conflict with an entity's risk management strategy. The AASB is supportive of departing from the principle in relation to cash flow hedges of net positions, as it is not possible to reconcile the financial reporting construct with the risk management approach. Therefore, the IASB should justify the decision to deviate from the objective.

Presentation (paragraphs 37, 38, B79-B82 and BC174-BC177)

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Yes. The AASB supports the separate presentation of hedging instrument gains or losses from those line items affected by hedged items in profit or loss as this presentation avoids artificially grossing up gains or losses on the hedging instrument.

Disclosures (paragraphs 40-52 and BC183-BC208)

Question 13

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

The AASB supports the proposed disclosure requirements, especially in respect of an entity's risk management strategy. However, there are concerns that those entities choosing to apply hedge accounting would be required to comply with extensive disclosure requirements, while those entities that elect not to apply hedge accounting do not (as the requirements will only apply to entities that apply hedge accounting). Presumably the disclosures are intended to lead to clearer and more transparent reporting about an entity's risk management strategy and hedging activities, yet many entities would not be making those disclosures.

In addition, the AASB believes the IASB should consider how the existing disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* paragraph 33 (which consider the exposure to risks for which an entity does not apply hedge accounting) interact with the proposed disclosures of paragraphs 44 and 45 (which require disclosures about the entity's risk management strategy, the risks that an entity is exposed to, how an entity manages those risks, including whether an entity hedges risky items in their entirety or hedges a risk component, and the effect of the hedging strategy).

Accounting alternatives to hedge accounting (paragraphs BC208-BC246)

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209-BC218)

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

Yes. For the reasons outlined in paragraph BC209-BC218 of the Basis for Conclusions, the AASB agrees that an entity should be able to account for contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements at fair value if that is in accordance with the entity's risk management strategy.

Accounting for credit risk using credit derivatives (paragraphs BC219-BC246)

Question 15

(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?

(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

The AASB is concerned with the proposal in respect of credit risk and the justification that "...it is operationally difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items...".

The AASB acknowledges that the spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements and that the methodology prescribed in IFRS 7 *Financial Instruments: Disclosures* may only deduce an approximate measure of the impact of credit risk. However, the IASB recently decided that a change in fair value due to own credit risk would be presented in OCI for financial liabilities designated at fair value through profit or loss and that the IFRS 7 methodology is a suitable proxy for determining the fair value change due to credit risk.

The IASB should be consistent in its decisions regarding credit risk – if it is satisfied that the fair value change of a financial liability due to a change in the entity's credit risk can be measured sufficiently reliably to be presented in OCI, then it is not clear why financial institutions should not be able to achieve hedge accounting for credit risk.

The IASB has justified its decision by stating that hedging against credit risk is unlikely to meet hedging requirements because the value of the credit derivative cannot be expected to move in the same way as the value of receivables and it is not possible to measure the credit risk element of the receivable. However, the Australian financial institutions consulted by the AASB are of a different view.

More generally, the AASB believes the IASB should specifically consider how to account for the impact of credit risk as it is becoming an increasingly significant issue in the application of IFRSs.

Effective date and transition (paragraphs 53-55 and BC247-BC254)

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

The AASB has a number of concerns with the proposed transition requirements and believes the IASB should reconsider the proposals.

(a) *Meaning of prospective* – it is not clear whether the prospective transition requirements mean hedges that are already in place can be dedesignated and redesignated in accordance with the proposed requirements, or whether the proposals would only apply to new hedging relationships entered into after transition to the new hedging requirements. The AASB believes more guidance is needed in this area.

(b) *Once-off retrospective adjustments* – the AASB believes the requirements should accommodate retrospective application to legacy hedge relationships for those entities that wish to make adjustments. If a hedging relationship met the criteria in IAS 39 for hedge accounting at transition date, then the AASB believes that relationship should be able to be accounted for in accordance with the new hedge accounting requirements. This would help ensure consistency in accounting of all hedging relationships within the entity and reduce the burden on preparers by avoiding the duplication of work and the requirement to keep two sets of hedging books – one for hedging relationships accounted for under the old requirements and one in accordance with the new requirements

    In addition, allowing retrospective adjustments to hedging relationships designated under the existing IAS 39 requirements, which still qualify for hedge accounting under the proposals, would be consistent with the transition requirements in respect of hedge accounting in IFRS 1 *First-time adoption of IFRSs*. It will also ensure consistency across entities for the following types of examples:

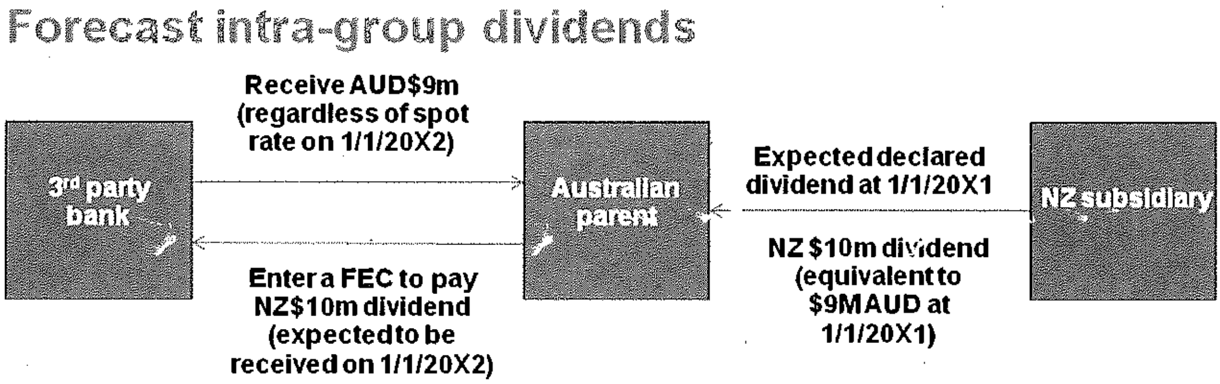
    (i) *Aggregated exposures* – there are different interpretations of the existing IAS 39 requirements in respect of synthetic debt with one interpretation resulting in ineffectiveness being recorded in profit or loss, while the other interpretation allows perfect hedge accounting. Therefore, those entities recording ineffectiveness under the existing requirements should be able to apply the proposed requirements and reverse ineffectiveness previously recognised in profit or loss and also avoid recording continuous ineffectiveness over the remaining life of the hedging instrument;

(ii) *Options as hedging instruments* – those that designated the intrinsic value of an option in a hedging relationship would have recorded the fair value changes of the time value of the option in profit or loss in accordance with existing IAS 39 requirements. Those entities would potentially want to retrospectively apply the proposed requirements and restate the fair value changes of the time value of the option from profit or loss to OCI. If some transitional relief were provided, it would link the objective of hedge accounting with the entity's risk management strategy in the comparative year as well as the current reporting period on transition;

(iii) *Hedging of net positions* – those entities with a risk management strategy to hedge a net position of sales and purchases are incapable of achieving hedge accounting under existing IAS 39 requirements, and must therefore designate a portion of gross sales as the hedged item instead. Those entities should be able to align the accounting of those transactions with their risk management strategy.

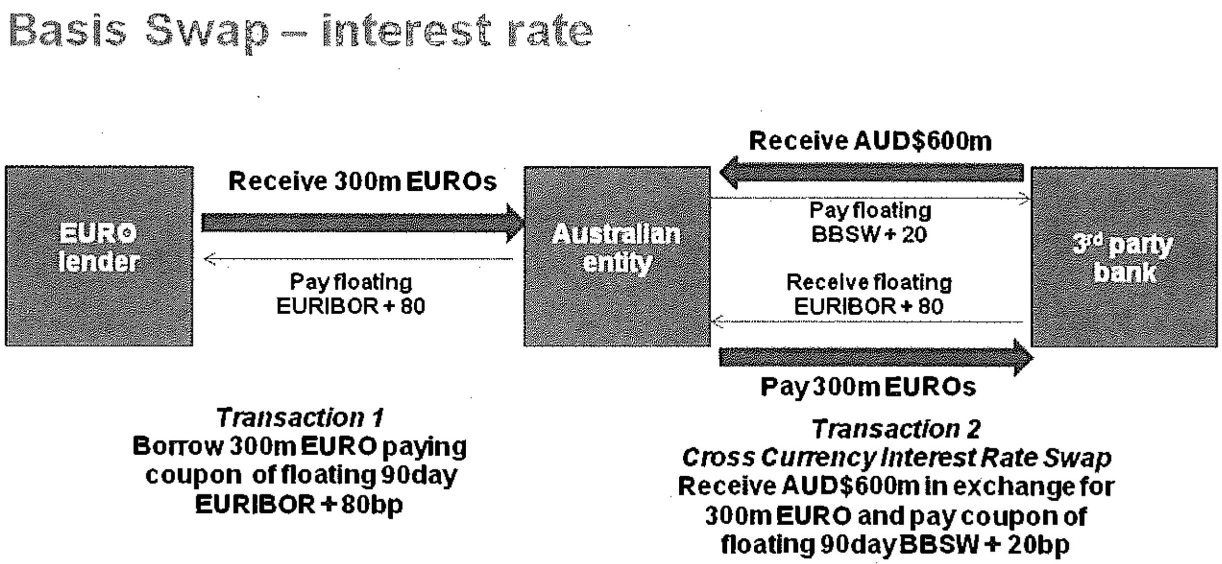
TRANSACTIONS THAT ARE UNDERTAKEN IN ACCORDANCE WITH THEENTITY'S RISK MANAGEMENT STRATEGY, BUT THAT ARE NOT ELIGIBLE FOR HEDGE ACCOUNTING

(1)



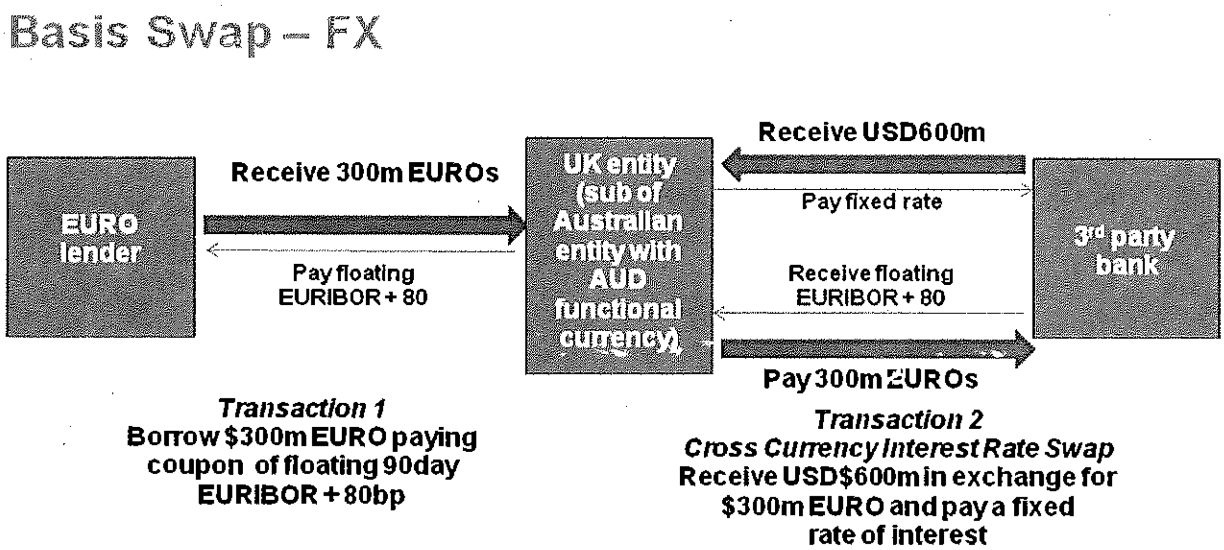
The above transaction is a common risk management strategy, especially in financial institutions, that for budgetary purposes, hedge the expected dividend from a foreign subsidiary. Under the current or proposed hedge accounting requirements, the consolidated entity cannot designate the expected declared dividend as a hedged item. We are aware that as a consequence of this, the entity will designate another 'item' in the balance sheet as the hedged item in the hedging relationship in order to achieve hedge accounting and to avoid the volatility of the forward exchange contract being recognised in profit or loss.

(2)



The above transaction is another example of a hedge transaction that does not achieve hedge accounting either under IAS 39 or the proposed requirements because the entity is still exposed to variability in cash flows due to the floating interest rate.

(3)



This is an example of a UK entity that has adopted its parent's functional currency (AUD). The entity may convert its Euro borrowing to USD in accordance with its risk management strategy. However, the entity does not achieve hedge accounting because it is still exposed to foreign currency risk.